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SUBJECT: Clark Firms Mull Closure with Huge Tax Burden

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Summary

1. (SBU) Businesses in the Clark Special Economic Zone face huge new financial liabilities after a recent Supreme Court decision nullified their tax incentives. U.S. company executives complain that the ruling replaces their 5% gross income tax with the standard 32% corporate income tax and other duties, and applies retroactively. AOL, for example, may owe about \$580 million. Although actual collection is on hold while the Court debates a reconsideration request, firms are forced to put aside funds for the higher tax assessments and inform stockholders of the amount owed. Several U.S. firms have postponed expansion plans and others have started looking for relocation sites. In response to protests by business organizations, the Philippine Congress drafted bills to reinstate the tax incentives at Clark and grant amnesty for prior year assessments. With other priorities occupying Congressional attention, however, legislative efforts to reverse the impact of the court verdict may take time and require compromise, results that will amplify business anxiety and further undermine credibility in the Philippine investment climate. End summary.

Firms Face Vast Tax Liabilities

2. (U) During an October 29 visit to the former Clark Air Force Base, econoffs talked to U.S. company executives about the recent Supreme Court decision that nullified tax incentives for businesses in the Clark Special Economic Zone. The executives expressed frustration and anxiety over the sudden imposition of higher tax rates and vast retroactive liabilities. The Court ruled that only Congress could grant tax and duty-free incentives so companies are no longer eligible to pay 5% gross income tax in lieu of the 32% corporate income tax and other duties. In addition, they must pay back taxes since the start of their operations, which for many companies is 5-10 years. As of November 1, with the implementation of the expanded value added tax (EVAT) law, companies in Clark will be assessed the new higher corporate income tax rate of 35%.

3. (SBU) All the U.S. companies strongly opposed paying back taxes and felt betrayed by government leaders who signed contracts promising special tax rates and benefits. Alan Arnett, Vice-President and General Manager for API, which runs an aircraft parts distribution hub for Asia, complained that by taking away tax benefits the government had "changed the rules mid-game," hurting GRP credibility and reducing the Philippines' competitive advantage. Noting confusion about the impact of the newly implemented tax law, Arnett said his accounting firm advised him to start paying VAT right away. Nenette Qua, Senior VP and General Manager of Amertron, an electronics manufacturer with 1200 employees in Clark, complained that her company had signed contracts with clients and could not go back and change its prices now to reflect the higher costs. Even firms outside of manufacturing or sales will face large back taxes. Ting Tottoc, Human Resources Manager at America Online, which runs a large help desk and customer service center, said the Bureau of Internal Revenue computed AOL's retroactive taxes as 32 billion pesos (\$580 million) based on operating costs for the last seven years.

Should I Stay or Should I Go

4. (SBU) Arnett said he placed API's multi-million dollar

expansion plans temporarily on hold until Congress finds a way to reinstate the tax incentives. But the company is experiencing major growth right now and cannot slow down to wait for GRP to straighten out its policies. As a result, soon after the Supreme Court decision was announced, API began site selection for a new plant in China. Other U.S. firms have also postponed additional investment and are looking for relocation sites.

-- AOL's long-term lease expired in August and the company has postponed renewing it. AOL may pack up and transfer its operations to Bangalore if the incentives are permanently withdrawn.

-- Bill Tackett, President of Infinno, a software development company, said the incentives are the only reason he set up his business in Clark. If these are lost, Infinno will move to Subic or out of the Philippines entirely.

-- Gillian Sim, General Manager of UPS, which runs an intra-Asian hub from Clark, said UPS will not leave immediately. The company has invested millions of dollars in renovating the airport and ground facilities, she noted, and may find it difficult to identify a substitute location on short notice.

-- Elizabeth Castro, BerthaPhil business park President, said the ambiguous state of tax incentives discourages new companies from locating in Clark. BerthaPhil is unable to lease open business park facilities because companies will delay signing a contract until they are guaranteed the tax incentives.

Sluggish Congressional Response

15. (SBU) Although the executives expressed confidence that the tax incentive issue will eventually be resolved, they expected to pay some additional taxes. Tackett admitted that "the government needs money" and lamented that it may be unwilling to give up all the potential revenue. In the meantime, the BIR issued a directive that firms should "hold off" paying the new taxes until the Supreme Court has ruled on this issue with finality. The Clark Development Corporation filed a motion for reconsideration with the Supreme Court that would postpone execution of its decision for at least a year, during which time the matter could hopefully be resolved in Congress.

16. (SBU) Business organizations have complained about the impact of the ruling on firms in Clark and the Philippine investment climate in general and urged Congressional action to prevent any commercial fallout. The Clark Locator Council announced that investors were planning to leave if the government failed to reinstate tax incentives. The US-ASEAN Business Council, which raised this issue during President Arroyo's visit to New York in September, requested a letter to confirm verbal assurances by Department of Finance and Bureau of Internal Revenue to suspend "ordinary business tax" collection until the situation is corrected in Congress. The Joint Foreign Chambers of the Philippines sent a letter requesting Arroyo to certify as "urgent" the legislation to reinstate incentives and grant amnesty for back taxes.

17. (SBU) GRP legislators expressed general support for tax incentive legislation but have not made it a priority. President Arroyo and House Speaker Jose de Venecia told U.S. companies that 75% of Congress was in favor of a Clark amnesty bill. Bernie Sayo, Presidential Legislative Liaison, told econoffs that a House resolution has been pending since May with no movement, though, and must be transformed into a bill to amend the law. While business councils acknowledge the "genuine" concern of Congress, members still fear legislation will take months to pass because of other political priorities, such as Constitution change, and lingering controversies over the Presidential impeachment attempt.

18. (U) The Senate drafted a bill to reinstate the tax incentives and planned to release a Committee report, but cannot finalize its version until the House passes its bill first, according to Sayo. The report will recommend amnesty from back taxes and reinstating incentives, said Attorney Custodio of Senator Gordon's office. Lauro Ortile, Manager of Corporate Planning at CDC, said legislators reassured him that the bills resolving the issue would pass quickly, and Clark investors are likely to receive even more generous incentives than they had before.

Comment

19. (SBU) CDC and BOI officials are making every effort to accommodate Clark businesses in the short-term and GRP officials claim a resolution is near. Although business

leaders remain optimistic, Embassy is concerned that the experience of U.S. investors in Clark may parallel that of local and foreign banks in the Philippines that lost their tax exemptions on foreign currency accounts without warning and were assessed millions of dollars in back taxes after a protracted resolution process (reftel). Even with a return to the status quo ante, the Supreme Court ruling and legislative foot-dragging over this matter have damaged the credibility of the government and called into question its ability to offer investment incentives without judicial interference.

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